Introduction

Context and Content

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Economic calamities create and shape central banks. The financial crisis of 1907, for example, led to the formation of the Federal Reserve System in 1914. The Great Depression and subsequent crises – along with changes in economic theory and political pressures – have altered the Federal Reserve's structure and responsibilities a number of times over the past century. The Great Recession saw the Federal Reserve and many of the world's other key central banks push several of their traditional policy operations in decidedly nontraditional directions. These actions have brought praise from some quarters and criticisms from others, but they now have precedence. The Great Recession – like the Great Depression – is likely to caste a long shadow over the institutional arrangements and policy operations of the world's central banks for years to come.

To deepen our insights into these developments, the Federal Reserve Bank of Cleveland invited some of the world's leading monetary, financial, and central-bank scholars to analyze them through the lens of economic history. The conference papers in this volume cover a wide range of issues – from the Federal Reserve's expanded lender-of-last-resort function to the prospects for European monetary union – and do what economic history does best: enhance economic theory with historical context. What better way to commemorate the Federal Reserve System's centennial?

In setting up this conference, the Federal Reserve Bank of Cleveland also sought to honor Michael D. Bordo for his considerable contributions to monetary and financial history. The design of this conference epitomizes Mike's work in terms of both the topics covered and the purpose. Michael Bordo often reviews the historical record with an eye toward distilling important lessons that can inform policy today. That is what most of the essays in this volume look to do.

The first chapter in this volume, however, is the exception. In his essay, Barry Eichengreen discusses both the benefits and the pitfalls of conducting such historical analyses. As such, the chapter functions as a user's guide, of sorts, to the conference papers. Human beings instinctively reason by analogy. History provides a "rich laboratory" of material against which to draw instructive comparisons about current economic developments. Such comparisons, as Eichengreen explains, can enrich policymakers' understanding of current events by filling in the context that economic modelers abandon in their search for parsimony. Historical analogy is particularly useful during economic crises, when events evolve quickly and discontinuously. Yet, reasoning from historical analogy presents dangers, and Eichengreen carefully lays out six pitfalls, which he often illustrates by referring to comparisons – so common of late – between the Great Recession and the Great Depression.

The next three chapters in this volume comment on aspects of the Federal Reserve's recent operations. Marvin Goodfriend, in his keynote address to the conference, focuses on the Federal Reserve's efforts to enhance its credibility through clearer communications. In January 2012, the Federal Open Market Committee – the Federal Reserve's main policymaking organ – issued a statement of its principles and goals for monetary policy. The statement, which announced a 2 percent inflation objective, looked to improve the Committee's transparency and accountability for U.S. monetary policy, and, thereby, to enhance the System's credibility with respect to achieving its policy goals. A credible monetary policy anchors inflation expectations. Goodfriend traces the historical origins of the January 2012 announcement. He first focuses on the Federal Reserve's response to five inflation scares during the Volcker and Greenspan chairmanships, showing how anchored inflation expectations can enhance the effectiveness of monetary policy. Goodfriend then recounts the Federal Reserve System's decisions to become more transparent through the release of the committee's transcripts and the eventual announcement of its federal-funds-rate target. He argues that the Federal Reserve could further enhance its transparency and accountability by distinguishing balance-sheet actions that are monetary policy from those that are credit policy. Goodfriend goes on to explain this crucial distinction and why it matters to central banks.

Allan Meltzer also looks to improve the credibility of U.S. monetary policy, and he favors a rules-based approach. Meltzer argues that the Federal Reserve's powers have greatly expanded since its founding, but at the cost of reduced policy independence. He sees rules-based policy as a shield against the greater potential for political influence over central-bank actions. Monetary policymakers will always confront uncertainties intrinsic to the economy, which rules-based policy will never perfectly overcome, but rules lessen uncertainties associated with how central banks themselves are likely to respond. That in itself fosters good economic outcomes. Meltzer contends that the Federal Reserve's greatest policy successes have occurred when the System followed rule-like policies. He notes, for example, that the Federal Reserve followed a Taylor rule between 1985 and 2003, with a sufficiently large weight on the inflation component to attain price stability. Such a Taylor rule, nevertheless, remained consistent with the Federal Reserve's dual mandate. Meltzer also worries that the Federal Reserve is currently conditioning policy too much on near-term developments, over which it has little influence, instead of on medium-term goals, which it can affect. Rules-based policy minimizes this problem. Moreover, if major countries all adopted rules that emphasized price stability, they could minimize exchange-rate uncertainty and, therefore, volatility.

The Federal Reserve's response to the financial meltdown of 2007–2009 was unmatched in its scale and scope, but it had precedence in the System's actions to stem earlier financial crises. Mark Carlson and David Wheelock trace the development of the Federal Reserve's lender-of-last-resort function from the System's founding through the recent financial crisis. Readers, who may conceive Bagehot's rule as the optimal guide for a lender of last resort, are left to understand how complicated these operations can be in a large, dynamic, and diverse financial climate. The chapter describes how the overall regulatory environment for the financial system and especially the banking system affects the likelihood that a central bank will need to act as a lender of last resort, the nature of any response, and the chances of its success. Carlson and Wheelock's review gives context to the Federal Reserve's recent actions, showing that the Federal Reserve's response to the financial crisis of 2007–2009 was not ad hoc. Its roots run long and deep.

Another way to think about the Federal Reserve's lender-of-last-resort function is to consider banking in its absence. Prior to the establishment of the Federal Reserve System, clearing houses undertook actions that many associate with modern central banks, notably they provided temporary liquidity in the form of clearing house loan certificates during banking crises. Monetary historians have suggested that clearing houses failed to stem banking panics during the National Banking Era because they issued insufficient amounts of loan certificates. If loan certificates were to overcome banking panics, banks had to borrow loan certificates in concert, substitute them for clearing balances, and then inject the cash from their clearing balances into the banking system. Relying on a unique set of data from the minutes of the New York Clearing House's loan committee, Jon Moen and Ellis Tallman investigate how the six largest U.S. banks used clearing house loan certificates during the 1873, 1884, 1890, 1893, and 1907 banking crises. Instead of concerted actions, Moen and Tallman find considerable variation in the biggest banks' use of clearing house loan certificates during panics, which suggests that these banks did not always internalize the beneficial externalities of providing liquidity to the broader banking system. They instead acted in their own self-interests.

Many who have criticized the scope of central-bank actions during the Great Recession have done so out of a fear that these actions have undermined central banks' independence. Forrest Capie and Geoffrey Wood explain that the concept of central-bank independence has always been somewhat nebulous. In theory, a central bank is independent if it is free of political influence. In practice, the definition is less clear cut, because governments create central banks that, in turn, provide services to the government. A completely independent central bank does not exist. Capie and Wood, drawing on the history of the Reserve Bank of New Zealand, the Band of England, and the Federal Reserve System, discuss central-bank independence as a set of governmental instructions to a central bank that expresses the government's intentions for that institution and are clear enough to measure its subsequent performance. Over the past twenty-four years, these instructions have focused on price stability and on the lender-of-last-resort function. During financial crises, governments reshape their central banks' mandate in ways that push central banks "into the arms of government" with unintended consequences for the bank's authority and reputation that linger after the crisis has passed. Capie and Wood wonder if the Great Recession has redefined the relationships between the Bank of England, the European Central Bank, and the Federal Reserve System and their respective governments in ways not consistent with the traditional definition of central-bank independence.

A byproduct of the Great Recession has been a sovereign-debt crisis within the euro area. Although a single currency promotes exchange among its members, it limits their ability to respond to country-specific economic shocks. Consequently, the European sovereign-debt crisis has created uncertainty about the longevity of the European Monetary Union. Peter Rousseau's contribution to this volume asks if political union is a necessary condition for successful monetary union. Rousseau points out that the United States achieved complete political and monetary union through lengthy processes, with the former culminating with the Civil War and the latter in the Federal Reserve System. He shows how the waxing and waning of centralist and decentralist views influenced the evolution of monetary practices and institutions in the United States. He argues, for example, that Andrew Jackson's actions against the Second Bank of the United States and the "specie circular," which seem antithetical to the establishment of monetary union, ultimately had positive consequences. Jackson's policies fostered the regional distribution of specie, and promoted a geographic dispersion of banking services that otherwise might not have occurred. The national bank acts – a centralist proposition – fostered a uniform currency, but did not eliminate state banks. With the Federal Reserve as a lender of last resort, the United States achieved equilibrium – one consistent with monetary union – between ever-evolving political and monetary forces. He expects the process to transpire similarly in Europe, though somewhat faster.

Harold James is also concerned with the process of European monetary union, and he notes that Europeans often turn to the United States for precedents on fiscal and financial integration. He focuses on two aspects of the U.S. experience that are particularly important to Europe today: The U.S. federal government's regard for state debts and the structural evolution of the Federal Reserve System between 1914 and 1933. As is well known, Hamilton in 1790 assumed state debts associated with the Revolution because they sprang from actions taken on behalf of the entire nation. James focuses on the less understood consequences of Hamilton's decision. He explains, for example, how the subsequent moral-hazard problem played out in the 1840s and 1870s and how the establishment of a revenue stream to service state debts had divisive distributional effects among the U.S. states. Drawing on U.S. precedents, James also explains that the design of a central bank governing a large geographic area – like the Federal Reserve – is complicated by a need to address local circumstances while ensuring the cohesive operation of the entire system. Adding further complexity, the design of the central bank may not fit evolving policy demands, as was the Federal Reserve's experience in the 1930s. Consequently, a process of institutional redesign is necessary.

In thinking about the European Monetary Union's current problems, Christopher Meissner draws an important parallel from an unlikely historical source. Meissner shows how France's preference for a bimetallic international monetary system could not compete with the growing international preference for a gold-based system. Moreover, he suggests that France's temporary suspension of silver convertibility in 1873, in conjunction with growing network economies, accelerated the international preference for gold. Meissner estimates that France would have lost its gold reserves and ended up on a silver standard by 1875 had it persisted in its quest for bimetallism. Meissner's key broader point is that long-held perceptions about the viability of an institutional status quo can prove false, if those perceptions are not viable in all states of the world. European monetary union may be a case in point. Policymakers claim that those European countries experiencing sovereign-debt crises and undergoing difficult reforms will not have to vacate the European Monetary Union, but is this claim viable in all possible scenarios? Meissner sees close cooperation – which did not coalesce around bimetallism – as necessary for European Monetary Union.

The depth and duration of the Great Recession has naturally encouraged comparisons with the Great Depression. Kris Mitchener and Gary Richardson consider the role of interbank deposits as an avenue of financial contagion during the Great Contraction (1929–1933). Interbank deposits linked country banks, particularly nonmember banks, to financial centers in New York and Chicago. During the 1920s, interbank deposit flows were largely seasonal and not correlated with measures of bank distress. During the 1930s, however, interbank deposit flows became highly correlated with bank distress in the hinterlands and, consequently, transmitted financial shocks from the periphery to the center of the financial system. The increased volatility of interbank flows during the 1930s encouraged reserve-city banks to shift their portfolio out of loans and into government bonds and to accumulate reserves. Consequently, the volatility of these interbank deposit flows may have contributed to the severity of the Great Contraction. Mitchener and Richardson base their estimates on a new comprehensive data set for all banks in the United States aggregated at the Federal Reserve District level.

One important similarity between the Great Recession and the Great Depression is that in both, short-term interest rates approached their zero bound, weakening the conventional channels for monetary policy. During the Great Depression short-term interest rates effectively reached their zero bound in 1934 and remained there until 1940. Banks held substantial amounts of excess reserves, much like today. John Landon-Lane asks if quantitative easing would have worked during the Great Depression. Using a methodology that approximates an event study, he suggests that the Federal Reserve could have had a small effect on long-term government bond yields during the 1930s by purchasing such bonds. Moreover, Landon-Lane believes that changes in yields of long-term Treasuries would have passed through to corporate bond yields with a greater-than-proportionate impact on low-rated corporates. Quantitative easing could have helped during the Great Depression.

Another way to understand current U.S. policies is through comparisons with the Canadian experience. These can be particularly useful because both economies are similar, closely interconnected, and often experience common economic shocks. Economists can often trace differences between the Canadian and U.S. responses to similar economic shocks to variations in these countries' monetary policies and regulatory environments. Ehsan Choudhri and Lawrence Schembri first compare U.S. and Canadian monetary policies in the 1920s and the 2000s. They find that although Canadian monetary policy was somewhat more conservative than U.S. monetary policy in general, the former did not differ substantially from the latter because of Canadian concerns about adverse exchange-rate movements. Choudhri and Schembri then focus on differences between the countries' financial-stability policies. During the boom period of the 1920s, both the United States and Canada lacked effective financial-stability policies to control credit expansion. Both eventually had to use monetary-policy actions – a particularly blunt instrument. Canada and the United States learned from the experience and, during the Great Depression, introduced substantial changes to laws governing their financial systems. Prior to the recent crisis, however, the United States – unlike Canada – seems to have forgotten that lesson. Choudhri and Schembri attribute differences in Canada's and the United States' recent economic performances to differences in their mortgage-market and bank-regulatory policies.

The Great Recession originated from severe problems in the U.S. housing and mortgage markets, which Canada did not share. Angela Redish extends this volume's cross-border comparisons by reviewing the development of the mortgage markets in Canada and the United States. She relates this process to evolutionary differences to the structure of banking in each country. In Canada mortgages typically have a five-year duration. Consequently, banks in Canada do not face large maturity mismatches on their balance sheets and feel little compulsion to take mortgage loans off of their balance sheets through securitization, as do many banks in the United States, where the maturity mismatches can be considerable. In addition, extensive Canadian bank branching – not found in the United States – gave banks access to a nationwide pool of funds without securitization. The resulting stability in Canada, however, comes with costs: Borrowers must often refinance their mortgages, and banks may face a diminished capacity to access mortgage funding in international markets without securitization.

As noted, the papers in this conference generally reflect aspects of Michael Bordo's work in their breadth of topic, historical focus, and policy relevance. Hugh Rockoff and Eugene White pay tribute to Michael Bordo's rich contributions of monetary and central-bank history, but because the latter's contributions are so extensive – 244 published articles, chapters, surveys, and reviews by their count – the Rockoff and White chapter also serves as a quick survey of scholarly debates on leading issues in the field, particularly those issues of ongoing policy relevance. Among the many areas included in this chapter are the Great Depression, Canadian banking exceptionalism, the gold standard, financial crises, the lender-of-last-resort function, and the relevance of asset bubbles to monetary policy. The section entitled, Historical Guidance for Monetary Policy, for example, includes a compact discussion of the lender-of-last-resort function that briefly discusses external factors that can lead to banking crises, explains why private-sector solutions to banking crises are inadequate, and progresses to the role of open-market operations in such cases. A neophyte monetary historian can find no better starting point than this chapter and Michael Bordo's body of work.

After earning his undergraduate degree from McGill University and a master's degree from the London School of Economics, Bordo received his Ph.D. from the University of Chicago under the tutelage of Robert

Fogel, Harry Johnson, Robert Mundell, and Milton Friedman, his thesis advisor. While working on his thesis, Mike spent a summer at the National Bureau of Economic Research, where he met Anna Schwartz, with whom he frequently collaborated over the next forty years. Bordo is a Research Associate of the National Bureau of Economic Research and a Distinguished Visiting Fellow at the Hoover Institution.

Michael Bordo's concluding essay brings the conference full circle. Bordo notes that traditionally central banks have performed two tasks: they have maintained the purchasing power of money and, in the face of temporary liquidity shocks, served as a lender of last resort to banks – those institutions that provide the means of payment. He argues for the maintenance of this traditional model. In the aftermath of the recent financial crisis, many have called for central banks to adopt a broader mandate for financial stability, including the monitoring of asset prices and the wider financial system. Bordo contends that broad financial stability concerns should fall under the purview of a separate authority or, at a minimum, should not involve the traditional tools of monetary policy. To do otherwise, risks making central banks adjuncts to fiscal policies.

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The Uses and Misuses of Economic History

Barry Eichengreen

There is a long tradition in economics of making use of historical events and episodes in an effort to shed light on current policy concerns. Earl Hamilton's famous work on the sources of Spain's sixteenth-century inflation appeared, not coincidentally, in the wake of the European hyperinflations of the 1920s.[1] Gayer, Rostow, and Schwartz in *Growth and Fluctuations of the British Economy*; Rostow in *Stages of Economic Growth*; and Gerschenkron in *Economic Backwardness in Historical Perspective* turned after World War II to Britain, America, and Continental Europe's historical experience with industrialization and economic development precisely because this was when economists were preoccupied with how industrialization and modern economic growth might be encouraged in the newly independent nations of Asia and Africa.[2] One would be remiss to not also mention Friedman and Schwartz's *Monetary History of the United States*, which looked back not just at the Great Depression but also at earlier U.S. monetary experience and was written as a reaction against the tendency after World War II to downplay the role of monetary policy in economic fluctuations, most visibly in the United Kingdom but also generally.[3]

This kind of policy-oriented or "presentist" history subsequently fell out of fashion. (The term in quotes is from Mariano 2000, who uses it to characterize the work of the American political historian Arthur Schlesinger Jr., who was notorious among his purist colleagues for high-profile attempts to use history to speak to current events.) To be clear, economic history

This chapter draws on my 2011 presidential address to the Economic History Association, since published in the *Journal of Economic History* (June 2012).

1 See Hamilton (1934).
2 The references are to Gayer, Rostow, and Schwartz (1953); Rostow (1960); and Gerschenkron (1964).
3 See Friedman and Schwartz (1963).

never went away.[4] But it is fair to say that research in economic history in this period was not intimately connected to policymaking.[5] Economic historians did not serve on the Board of Governors of the Federal Reserve System, on the President's Council of Economic Advisors, or in other policy positions.[6] Historical scholarship was not widely invoked in policy discussions.

How markedly the current state of affairs differs from that of the late 1960s and early 1970s has been highlighted by the role that research in economic history played in the policy debate over how to respond to the financial crisis and Great Recession of 2008–2009. As I have noted elsewhere, there was a sharp increase in references in the press to the term "Great Depression" following the failure of Lehman Bros. in September 2008.[7] There was also a surge in references to "economic history," first in February of 2008 with growing awareness that this could be the worst recession since the 1930s, and again in October, coincident with fears that the financial system was on the verge of collapse. Journalists, market participants, and policymakers all turned to history for guidance on how to interpret and react to an otherwise unprecedented news flow – unprecedented, that is, if one looked back fewer than eighty years. In March 2009, at the height of fears that we might be slipping into a new depression, the Council on Foreign Relations convened a symposium on the 1930s Depression and New Deal.[8] Today, as attention turns from the danger of financial collapse to disappointingly slow growth and chronic debt problems, comparisons with the aftermath of earlier crises and the extent to which they were also accompanied by slow growth and sovereign debt problems are again rife.[9]

[4] To the contrary, it continued to be actively practiced and taught. The 1960s, when Mike began his graduate work, and the 1970s, when the young Professor Bordo rose to prominence, were precisely when the so-called new economic history flourished.

[5] One might wish to qualify this generalization by observing that some influential early contributions to the new economic history did, in fact, have important connections to the policy issues of the day, although the extent to which they influenced contemporary policy debate is another question. Thus Fogel and Engerman's *Time on the Cross* drew inspiration in part from the Civil Rights movement of the 1960s, and McCloskey's *Economic Maturity and Industrial Decline* was inspired in part by the contemporary debate over British economic performance.

[6] As they have recently. Walt Rostow may have been one of the last of his generation (am I missing others?).

[7] This according to Google Trends, as reported in Eichengreen (2012).

[8] Mike was there (I was not).

[9] Reinhart and Rogoff (2009) is the most widely cited and purchased (if not always read) example of the genus, but it is far from alone. Macmillan (2009, p. 9) describes how it seemed during the Cold War that the history of earlier conflicts seemed to have lost much of its power. "The world that came into being after 1945 was divided up between two great alliance systems and two competing ideologies, both of which claimed to represent the future of humanity.... The old conflicts between Serbs and Croats, Germans and French, or Christians and Muslims, were just that and were consigned, in Leon Trotsky's memorable